

***United States Court of Appeals
for the Second Circuit***



**APPELLANT'S
BRIEF**

77-5003

To be argued by

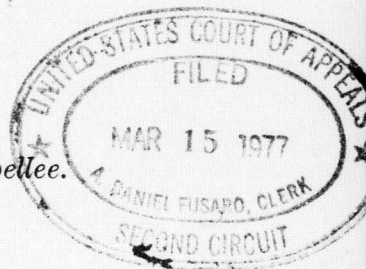
ANTHONY J. D'AURIA

IN THE
United States Court of Appeals
FOR THE SECOND CIRCUIT

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Docket No. 77-5003

IN RE
THE FABRIC TREE,
Debtor-Appellee.



MANGEL STORES CORPORATION,
Appellant.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE
SOUTHERN DISTRICT OF NEW YORK

BRIEF OF MANGEL STORES CORPORATION,
APPELLANT

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**BRIEF OF MANGEL STORES CORPORATION,
APPELLANT**

ISSUES PRESENTED

1. Whether the Bankruptcy Court had jurisdiction to enforce a contract between appellant and the chairman of the creditors committee of The Fabric Tree, Inc. ("Fabric Tree"), a Chapter XI debtor, pursuant to which appellant, on certain conditions, undertook to fund Fabric Tree's arrangement, when:

- a) Fabric Tree was not a party to the contract;
- b) the contract did not involve property in which Fabric Tree had any interest; and

- c) the contract was not required to be and was not submitted to the Bankruptcy Court for its approval.

2. Whether appellant was deprived of an adequate opportunity to defend itself against a forfeiture of \$600,000 in circumstances where appellant (a) received no complaint notifying it of the claim against it; (b) was not notified of the issues to be tried until the very commencement of the evidentiary hearing; (c) was denied an opportunity to take discovery because of the precipitous manner in which the hearing was called; and (d) received none of the protections to which it would have been entitled if the requirements for the conduct of an adversary proceeding established by the Rules of Bankruptcy Procedure had been followed.

3. a) Whether in circumstances where Fabric Tree was suffering continuing losses in its operations and it was imperative, if it were to continue in business, that orders for the fall season be placed no later than July 15, 1976, time was of the essence under a contract requiring that Fabric Tree's arrangement be confirmed not later than July 15, 1976 and that its general unsecured debts not exceed \$450,000 and that its administrative and priority expenses not exceed \$150,000 on the date of confirmation.

b) Whether Fabric Tree, in order to meet the contractual requirement that its administrative and priority expenses not exceed \$150,000, could properly use funds belonging to appellant and resulting from the sale of inventory financed by appellant, to retire administrative and priority expenses incurred prior to the execution of the contract.

**Statement of the Case, Nature of the Case
and Course of Proceedings**

This is an appeal from an order entered on January 11, 1977 by the Honorable Henry F. Werker affirming an order entered on August 2, 1976 by the Honorable Roy Babbitt, Bankruptcy Judge, acting in the absence and at the request of the Honorable Stanley T. Lesser, Bankruptcy Judge, confirming the arrangement of the debtor in possession, Fabric Tree, Inc. ("Fabric Tree"), pursuant to Chapter XI of the Bankruptcy Act. As a result of the orders below, appellant Mangel Stores Corporation ("Mangels") will be compelled to fund the arrangement at a cost of \$600,000.

The genesis of this appeal is a contract entered into between Mangels and the creditors committee of Fabric Tree pursuant to the terms of which Mangels deposited \$600,000 in escrow and agreed that that sum could be used to fund a plan on the conditions that the administrative and priority expenses of the debtor* be no greater than \$150,000, that no more than \$450,000 be required for the payment of allowable unsecured claims, and on the additional condition that the plan be confirmed by July 15, 1976.

Mangels has maintained throughout this proceeding, and it never has been seriously contested by any of the parties hereto, or by Judge Lesser, that none of those conditions were met. Nevertheless, the Bankruptcy Court, in a proceeding that defies statutory description and without the benefit of any pleadings or discovery, summarily concluded

* As used in the context of Chapter XI of the Bankruptcy Act, "administrative expenses" refers to all indebtedness incurred by the debtor in possession after the filing of the petition for an arrangement in the operation of its business plus all court-awarded professional fees and statutory costs of the proceedings. "Priority expenses" refers to those prepetition obligations which are given priority of payment over other prepetition unsecured debts pursuant to Section 64a of the Bankruptcy Act, 11 U.S.C. §104a (1970). Of course, administrative expenses are awarded a first priority under Section 64a(1) of the Bankruptcy Act, 11 U.S.C. §104a(1) (1970).

by oral opinion that the contract was not to be construed as it was written. The court then proceeded to confirm the arrangement and ordered that the escrow deposit be used to fund Fabric Tree's arrangement, including the payment of priority and administrative expenses.

The District Court sanctioned the procedure used below, adopted the conclusions of the Bankruptcy Court and affirmed its order.

It is Mangels' position on this appeal that the orders of the courts below were beyond their powers jurisdictionally and erroneous on the merits.

The Facts

For some time prior to 1975, Fabric Tree was engaged in the business of selling yard goods, notions and the like from a number of retail outlets. In August, 1975, it sought the protection of the Bankruptcy Court and filed a petition under Chapter XI. In April, 1976 Mangels began discussions with Fabric Tree's creditors committee and its principals with respect to the acquisition of Fabric Tree's operations and the funding of an arrangement. As will hereinafter be demonstrated (pp. 35-38) at the time of these discussions, Fabric Tree could not state with certitude what the amount of its administrative and priority debts were. However, Mangels was not willing to assume an unlimited commitment to pay those debts. On the contrary, it was interested in purchasing Fabric Tree only if the cost of that purchase was limited and only if it received in exchange, a company discharged of all general, administrative and priority debts. Thus, on May 4, 1976, Mangels entered into three agreements in the belief that, except for the losses incurred between May 4, 1976 and the date of confirmation and which it agreed to finance, the amount of its undertaking was limited and certain:

1. An agreement between Mangels and the creditors committee of Fabric Tree (A 240)* by which Mangels offered to fund an arrangement on these conditions: that the unsecured claims be satisfied by the payment of an amount not greater than \$450,000; that all administrative and priority expenses be no greater than \$150,000; and that a plan be confirmed by July 15, 1976.

2. An agreement between Mangels and the principals of Fabric Tree wherein Mangels agreed, subject to confirmation of the plan under the above conditions, to employ the principals and to buy their stock for \$1 plus an amount based on an earnings formula (A 216).

3. An agreement between Mangels and Fabric Tree wherein Mangels agreed to lend to Fabric Tee \$338,360.86 to repay a recent supplier. The agreement further contemplated that Mangels could, in its discretion, lend to Fabric Tree additional amounts for merchandise purchases (A 243). As collateral for this loan Mangels received a security interest in all of Fabric Tree's assets.**

Pursuant to the agreement with the creditors, Mangels delivered to the chairman of the creditors committee, in escrow, a certificate of deposit issued to Mangels' order in the amount of \$600,000. If the aforementioned time and amount conditions were met, the proceeds of the certificate were to form the required statutory deposit for confirmation

* Reference is to the page of the joint appendix.

** Only the loan and security agreement was required to be submitted to the Bankruptcy Court for approval. Approval was obtained on May 7, 1976. Since the two other agreements were not with the debtor, but with its creditors in the one instance, and its principals in the other, they were not required to be submitted for approval. If there were any obligation to do so, it rested upon the debtor and the creditors committee, since Mangels was not a party to the bankruptcy proceeding.

of an arrangement. Bankruptcy Act § 362(2), 11 U.S.C. § 762(2) (1970). The agreement stated that \$450,000 was to pay all unsecured claims and \$150,000 to pay "in full all of the priority and administration expenses. . . ." After providing for a termination date of July 15, 1976, the agreement stated that "[I]n the event that either of the foregoing conditions is not satisfied, [the escrowee] shall return the Certificate of Deposit. . . ." to Mangels.

No claim has been made, nor could it be, but that after the execution of these agreements Mangels adhered strictly to their terms. It did, in fact, advance substantial credit to Fabric Tree so that by July 15, 1976 its total exposure was in excess of \$700,000 (A. 179). (This amount is wholly apart from the \$600,000 certificate of deposit.)

Although Mangels was performing its part of the contracts, by the end of June it became apparent that the creditors committee and Fabric Tree were having difficulties performing theirs. Mangels' inquiries with respect to the efforts to have the creditors reduce their claims were never satisfactorily answered (A. 189-90). Finally, two meetings to discuss the matter were held at the end of June with the parties. At both meetings Joseph Lamm, president of Mangels, made clear that while Mangels was quite prepared to go forward with the transaction, it would insist on performance of the conditions both with respect to the amount of the debt and the date of confirmation (A. 176, 177, 179, 180). As Mr. Lamm testified:

"I stated that without any equivocation, unless they bring it down to \$600,000 by July 15th, we will not permit the confirmation to go through" (A. 176-7).

And again:

"I don't recall the exact statement, but I do know that I was quite assertive in my statement that we

will not go through with the confirmation if we have to put up as much as \$600,000 and one penny.

That is what I remember saying exactly" (A. 178-9).

Thus, as early as June 24 (the day of the first meeting) and certainly no later than June 29 (the day of the second meeting) Mangels' position with respect to the conditions of the contract was clear. At or about the same time, Mangels discovered that Fabric Tree was using the funds generated from the sale of the inventory financed by Mangels to pay noncurrent administrative debts incurred prior to May 4, 1976 so as to meet the dollar conditions of the agreement (A. 166-172, 196-200). This was, of course, contrary to all reasonable expectations since Mangels fully expected the \$150,000 provided for in the agreement to cover all prior administrative expenses and never contemplated that it would be the source of the funds that would permit Fabric Tree to meet the \$150,000 limitation of debt (A. 199-200). (See Argument *infra* pp. 35-38.) Mangels' attempts to stop this practice proved unsuccessful and Fabric Tree continued to use the proceeds from current operations to pay noncurrent (*i.e.* administrative expenses owing prior to May 4, 1976) as well as current debts in a desperate but unsuccessful attempt to meet the contract terms (A. 172, 202). The only reason this was possible, of course, was because Mangels and not Fabric Tree was paying for the latter's inventory purchases. Thus, although Fabric Tree was losing money from operations, cash was realized by Fabric Tree from the sale of merchandise financed by Mangels which cash was used to carry out this scheme.

This, then, was the status on July 15, when the matter was called on Judge Lesser's calendar. It is unfortunate that no transcript of the proceedings that day, much of

which were "off the record" in any event, was made. But since both courts below felt free to refer to the events of that day as the starting point of their analyses, a recitation of what actually transpired is required.

At the outset on July 15, counsel for Fabric Tree advised the court that the conditions of the agreement had not been met. The court was told that allowable unsecured claims could not be satisfied by the payment of \$450,000 and that the administrative and priority expenses were greater than \$150,000 (even after Fabric Tree's improper payments to reduce that amount). Accordingly, counsel acknowledged that Fabric Tree was in no position to move for confirmation (A. 10-11, 38, 39, 41, 49).

Upon inquiry, Mangels advised the court* that it would not waive the conditions and brought to the court's attention the misuse by Fabric Tree of its collections and sales revenues. It is significant to note that Judge Lesser took no exception to Mangels' position. Indeed, since it was apparent that Fabric Tree had not met the conditions, Judge Lesser was then and there prepared to order Fabric Tree's adjudication in bankruptcy, which would have resulted in the immediate return of the escrow deposit to Mangels.

However, an immediate adjudication was not in the interests of Mangels or the creditors committee. A liquidation would have precluded the creditors committee from making other provisions for the sale or rehabilitation of Fabric Tree and might have seriously jeopardized the collectibility of Mangels' \$700,000 loan. Accordingly, without prejudice to its position, Mangels agreed to refrain from collecting the \$700,000 for thirty days (A 15). At that point, Judge Lesser directed that a status report be given to him on July 27.

* This was the first participation by Mangels or its counsel in this proceeding. Mangels did attend and observe some prior hearings, but neither formally appeared nor participated.

Thus, Mangels left the court on July 15 with the understanding that Judge Lesser and all parties accepted that the contract conditions had not been met. It fully expected the return of its escrow deposit and had no reason to believe that its actions or motives were subject to any criticism.

On July 27, counsel for Fabric Tree announced to the Court that he believed the \$600,000 figure could then be met (A 8-12), although even then he was not in a position to move for confirmation. He told the court that at a meeting of the creditors committee held just the day before (11 days after the matter should have been concluded) the members had agreed to reduce their own claims and the professionals to reduce their court-awarded allowances so as to meet the contractual conditions (A 8). Mangels advised the Court that it was then too late to revive the contract and that it declined to fund a plan even assuming that the conditions could then be met.

The court thereupon called for a hearing that very afternoon. Only four witnesses were called and only 154 pages of transcript were consumed. Two days later the court rendered a 55 page opinion from the bench,* holding in substance that Mangels had forfeited the \$600,000 certificate of deposit.

The Opinion of the Bankruptcy Court

In view of the fact that Fabric Tree had been in Chapter XI for almost a year, that the July 15 deadline was already past and that the debtor was not ready on July 27 to move for confirmation of a plan, the haste to hold a hearing asserting jurisdiction over an escrow which had never been submitted to the court for approval and to decide an issue

* Although the court suggested that a more formal opinion would be forthcoming, a search of the files reveals none was ever issued (A 272, 310).

with such substantial consequences to Mangels can only be characterized as unseemly. Moreover, in order to justify a reformation of the terms of the contract, the Bankruptcy Court painted a picture of Mangels and its motives having no relationship to the facts, and having no basis in the record.

Thus, Judge Lesser found that "in the latter part of June or certainly in the early part of July" Mangels determined to escape from its contract (A 297, 298, 279, 365). However, one searches the meager record in vain for any support for this finding. Certainly it could not have been based on Mr. Lamm's testimony since he unequivocally demonstrated his willingness to purchase Fabric Tree under the terms of Mangels' offer (A 180). Surely, that conclusion cannot be based upon the fact that when it was discovered that Fabric Tree was diverting proceeds and when it appeared unlikely that the contract conditions would be met, in "the last few days" (A. 159) before July 15, Mangels reduced the amount of credit it had been advancing to Fabric Tree. Any other course would have been foolhardy, a fact even Judge Lesser was compelled to recognize (A 292). Mangels, which was under no obligation to advance additional credit, could not prudently make advances or guarantee payment for purchased inventory when it appeared that the proceeds of its credit were being used to bail out old debts and that the creditors committee and Fabric Tree would not be able to deliver on their end of the bargain. To ascribe a bad motive to what was an exercise of prudent business judgment, with no other evidence, is simply unwarranted.

There is equally no evidence in the record to support the Court's findings that "Mangels hindered performance of the condition" (A. 296) or that the delay in meeting the condition was "pretty much of Mangels own making" (A. 305). The record is barren of any evidence showing that Mangels did or failed to do anything that affected Fabric Tree's

ability to reduce creditor claims to meet the \$600,000 formula. Thus, there is no showing that Mangels entered into a cabal with the creditors to have them stand firm on the amount of their claims. There is no evidence that Mangels took any position other than that the conditions had to be met. In point of fact, Judge Lesser himself was prepared to adjudicate Fabric Tree on July 15. In these circumstances, the court's finding that somehow Mangels "hindered" or "delayed" the plan is simply unsupportable.

The Court's findings that confirmation, though not accomplished, was not in jeopardy on July 15 (A. 294) that its consummation was foreseeable and was likely to occur "in a few extra days" (A. 294) are contradicted in the opinion and record themselves.

As counsel for the debtor acknowledged:

"Mr. Cramers: As we had told you on the 15th by reason of the priority claims, particularly pre-Chapter XI taxes, exceeding the amount that had been projected and by reason of other administration claims arising which would have to be considered as part and parcel of 'unpaid administration expenses,' the \$150,000 figure in the Mangel's commitment proved to be inadequate" (A. 10, 11).

The Court itself stated:

"The fact of the matter is that whatever waivers were required in order to bring you down to the \$45,000 [sic] or the \$150,000 which were not on hand on the 15th—what does the paper work look like on confirmation?" (A. 38).

Even as of the date of the opinion the Court was not clear as to the amount of the debts (A. 306) and was forced to admit that the problems affecting confirmation were not nominal on July 15 (A. 316).

Finally, even as late as July 30th (the date of the opinion) the Court was not convinced that the debtor could

meet the \$600,000 condition and set August 4th as the final cut-off date (A. 308). The court stated:

"That being the case, it seems to me that confirmation now, if it is not possible today, *which it is not* and I don't know what the paper situation is, should be concluded by the close of business on the 4th of August. . . . In the event that this is not done, unless by further interference by the Mangels* it would seem to me that reasonable opportunity to satisfy the purpose and intent of the July 15 condition has been given and has failed" (A. 308). (Emphasis supplied.)

In view of the court's own uncertainty on July 30 as to ultimate confirmation, its conclusion that it was a virtual certainty on July 15 is unreasonable. And the extension by the Court of the deadline to August 4 contradicts its finding that just a "few days delay" was involved.

The court's finding that there was a lack of candor on Mangel's part (A. 296) since it had an "affirmative obligation" to make its position "crystal clear to everyone" (A. 299) is similarly unsupported. There is no case or statutory authority supporting the imposition of an "affirmative obligation". Secondly, the record is uncontradicted in its showing that Mangels informed the debtor of its position as early as June 24 (A. 176, 177, 179). Indeed, even counsel for the creditors committee acknowledged that it was aware of Mangel's position with respect to the \$600,000 condition, though he claimed the debtor had not informed him of the importance of the July date** (A. 49, 50). In view of

* As noted above, there was no evidence of prior interference.

** Mr. Fabrizio's (counsel for the committee) admission in this regard shows that the situation was not as the Court portrayed in its opinion. Because of the haste with which the hearing was called Mangels did not have an opportunity to take discovery of the members of the creditors committee or to call them as witnesses in order to determine the full extent of their knowledge. If nothing else, this demonstrates the infirmity of the proceeding below.

Mangels' early and clear statement of its position, and in light of the contract terms themselves, the court's conclusions that Mangels was remaining mute, that it was playing its cards close to the vest, that it gave no alert as to its position, and that everyone was surprised by its ultimate expression, are not warranted. Equally unwarranted is the thrusting upon Mangels of responsibility for the debtor's failure to advise the Court of Mangels' position before July 15. After all, it was the debtor and its counsel who were vitally interested in the outcome of the event. It was the debtor which was the only proper party before the court. And it was only the debtor and its committee which knew for sure whether the conditions would be met for it was only they who had the power to cause those conditions to be met. Nor is there anything the Court could have done had it been advised earlier, for it is the debtor's exclusive obligation to obtain financing for a plan and the Court does not concern itself with the necessary deposit for administrative expenses until a motion for confirmation is made. Bankruptcy Act § 362(2), 11 U.S.C. § 762(2) (1970).

If the debtor chose not to advise the court of the substance of its June 24 and 29 meetings with Mangels, its omission cannot form the basis of a finding of "bad faith" on Mangels' part. But here again the record does not support the finding, for the Court acknowledged, on the morning of the hearing, that there had been prior indications of Mangels' position to insist on both conditions in the contract (A. 47). Thus, the Court's characterization of Mangels' position as a "bombshell" is contrary to the record.

It is these findings which form the warp and woof of the Court's conclusion that Mangels had not sustained its burden of proving that performance of the contract by July 15th was essential. Stripped of these unsupported findings, it is clear that there is no basis for the court's decision.

The Opinion of the District Court

The opinion of the District Court adopts virtually all of Judge Lesser's conclusions and continues the negative characterization of Mangels' actions. In one major respect it goes even further than the Bankruptcy Court: early in his opinion, Judge Werker states that whether the conditions of the contract had been met on July 15 "is a matter of dispute on this appeal" (A. 328). But there is no dispute on this point.

On July 15 Fabric Tree did not and could not meet the conditions as to the unsecured debt and administration and priority expenses even if Mangels' challenge as to Fabric Tree's use of operating funds were disregarded. That is, even if Mangels had made no such claim, more than \$600,000 was needed on July 15 to confirm the proposed plan which had been accepted by Fabric Tree's creditors. The District Court's misconception of this point continues throughout its opinion. Thus, at page 11 of the opinion (A. 337), Judge Werker concluded that Mangels prevented confirmation on July 15 because of its claim as to the misuse of proceeds. At page 3 (A. 329), Judge Werker stated that the hearing of July 27 was scheduled so that the "issue raised by Mangels could be adequately resolved. . . ."

However, the "issue raised by Mangels" did not become germane until after it had been announced on July 27 that, by virtue of waivers of debt, the \$600,000 condition could then (for the first time) be met were it not for Mangels' contention as to the manner in which that debt was reduced. Up to that point, Fabric Tree was continually in default in meeting the conditions. What the District Court failed to perceive, undoubtedly because of the meager state of the record, was that from July 15 to July 27, Fabric Tree and the creditors committee worked to meet the conditions by obtaining reductions of claims and waivers of distributions and professional fees so that it could be claimed that

there was potential, though tardy, compliance with the contract. Even Judge Lesser recognized that this claim could not have been made on July 15 because the waivers and reductions had not been secured then (A. 276, 294).

These are not the only instances where the opinion of the District Court is at variance with the facts as they actually are or with the record such as it is. At every critical juncture, the District Court accepted the conclusions and findings of the Bankruptcy Court. However, in view of the paucity of the record, the lack of clearly defined issues and the hardly exhaustive exposition of the positions of the parties, it is apparent that the conclusions of the Bankruptcy Court were based on matters outside of the record, or not on the record or feelings obtained in the course of the administration of the estate. The error of the District Court is that it accepted these conclusions without rigorous scrutiny and to the substantial prejudice of Mangels.

Mangels' Position

On this appeal, Mangels contests the jurisdiction of the Bankruptcy Court to pass upon rights under a contract not made with the debtor and not even submitted to the court for its prior approval. In short, Mangels contends that any action to enforce that contract, or to vindicate an alleged breach thereof, must be a plenary one, in a proper tribunal and between the parties to the contract. Here, the courts below intruded themselves as champions of a contracting party for whom they had no power to act.

Mangels also contends that it was denied due process of law. Even if the court had jurisdiction, it should not have declared the rights of the parties on so substantial a question in such a precipitous fashion. That is to say, Mangels was entitled, at the least, to the benefits of an adversary proceeding with defined pleadings and an opportunity for

discovery. Here the "case" against Mangels was instituted by statements of counsel, tried and concluded and a forfeiture of \$600,000 declared in a space of two days. Nothing in this case or in Mangels' conduct in connection therewith warranted this manifest denial of due process.

Mangels' position on the merits, simply stated, is that the contract it entered into, after arms'-length negotiations could not be remade by the Bankruptcy Court. It demonstrated, in the brief time allotted to it, that the conditions in question, far from being idle or hyper-technical, were rooted in sound business considerations. In the first instance, the July 15th performance date was inextricably tied into the credit being advanced by Mangels and served to limit its exposure in the event confirmation was not accomplished. Even Judge Lesser was forced to acknowledge that Mangels had a legitimate interest so to protect itself (A. 292).

Secondly, Mangels demonstrated that July 15th was critical from a business point of view, since that was the latest date orders could be placed to meet the important fall buying season (A. 142, 143, 145, 161, 162, 165, 180, 181). Indeed, the evidence shows that Mangels first desired a June 30th performance date and consented to the July date only during the negotiations (A. 143, 161, 180). It is significant that the court did not quarrel with this business concern either.

The cardinal error of the Bankruptcy Court is that without the benefit of expert or other testimony, it substituted its judgment for that of the parties and concluded that August 4 was a good a day for performance as July 15. And it is to this wholly unwarranted finding, and to its affirmance, that Mangels takes exception.

Similarly, Mangels contends that the courts below improperly determined that Fabric Tree ultimately met the \$150,000 condition. The evidence in this regard is uncon-

tradicted and shows that at the time the transaction was entered into the parties fully expected the \$150,000 to cover all of Fabric Tree's prior administrative expenses and priority claims. While Mangels agreed that Fabric Tree could use current revenue to pay expenses incurred after the date of the contract, it was never Mangels' intention that those revenues, generated from the sale of merchandise provided by Mangels itself, would be used to pay old debts so that the \$150,000 condition could be met (A. 193, 194). The decisions of the courts below to the contrary are inconsistent with the manifest intention of the parties and have the effect of stripping the \$150,000 condition of any meaning.

A R G U M E N T

POINT I

THE BANKRUPTCY COURT HAD NO JURISDICTION WITH RESPECT TO THE AGREEMENT BETWEEN MANGELS AND THE CREDITORS COMMITTEE.

Courts of bankruptcy are of statutory origin, and possess only such jurisdiction as is conferred upon them by statute. 8 Collier on Bankruptcy, ¶3.01[2] (4th Ed., 1976); *Chicago Bank of Commerce v. Carter*, 61 F.2d 986 (8th Cir. 1932). Unlike Judge Lesser below, Judge Werker recognized the futility of attempting to establish jurisdiction over the instant dispute through one of the three ordinarily recognized bases of summary jurisdiction in bankruptcy: (1) jurisdiction over the ordinary administration of the bankrupt estate, "proceedings in bankruptcy;" (2) jurisdiction over "controversies arising in proceedings in bankruptcy," Bankruptcy Act §2a(7), 11 U.S.C. §11a(7) (1970), where there is a dispute over property and the court can obtain

jurisdiction over the *res*; and (3) jurisdiction over "controversies at law and in equity, as distinguished from proceedings under this Act," Bankruptcy Act §23, 11 U.S.C. §46 (1970), if and only if the defendant consents to the exercise of that jurisdiction.

While recognizing the absence of any such traditional basis for jurisdiction, Judge Werker, in upholding the Bankruptcy's Court's exercise thereof, relied upon three cases which he stated stood for the proposition that "the exercise of summary jurisdiction has been upheld without a showing that there was property in the actual or constructive possession of the court or the debtor simply because a contrary ruling would undermine the effectiveness of the bankruptcy courts as a vehicle for the resolution of serious economic problems" (A 331). This statement is an unwarranted over-extension of the principles enunciated by the cases relied on. Judge Werker's view would render meaningless any restrictions upon the scope of summary jurisdiction in bankruptcy, despite clear statutory language and over 75 years of case law to the contrary.

The cases relied upon by Judge Werker are *Fox Metal Industries v. Frontier Home & Plumbing Co.*, 453 F.2d 1128 (10th Cir. 1972); *Governor Clinton Co. v. Knott*, 120 F.2d 149 (2d Cir. 1941), *appeal dismissed*, 314 U.S. 701 (1942); and *In Re Sherman Plastering Corp.*, 340 F.2d 915 (2d Cir. 1965). Judge Werker minimized the crucial distinguishing feature between those cases and the one at hand. In each of the cited cases, the Bankruptcy Court asserted jurisdiction over a dispute arising out of an agreement between a third party and the *court-appointed fiduciary* in charge of the daily administration of the case on the court's behalf. Each dispute involved moneys of the estate or due to the estate. Furthermore, in two of the three cases, the court itself had approved the agreement in question, and therefore, the nonperformance thereof by a third party clearly

constituted an imposition upon the court.* Thus, in the *Fox* case, principally relied upon by Judge Werker, the Court of Appeals, in sustaining the exercise of jurisdiction by the lower court, restated with approval the lower court's position as follows:

"... summary jurisdiction of the Bankruptcy Court should be asserted because Frontier, which made an agreement *with the Receiver* in May 1970, breached that agreement when it refused to render to Receiver the value of the two checks. The trial court's holding is that this agreement with the court appointed Receiver, and its performance, is a part of the *operation of the receivership under the court's supervision*. It is thus a *participation by Frontier with the Receiver in the function of the receivership itself, and not with Fox* [the debtor]. Such participation would, under this theory, place Frontier within the court's jurisdiction *over the receivership*." 453 F.2d at 1130. (Emphasis supplied.)

The court later states:

"In the instant case there is no allegation of fraud, but the refusal to honor an agreement with the Receiver worked an *imposition on the court*." 453 F.2d at 1131. (Emphasis supplied.)

Similarly, in *Governor Clinton*, the court itself had required the execution of the contracts by the debtor as a condition of remaining in possession, and that agreement was subsequently approved by court order. Furthermore, the contract performance issue over which the court exercised its jurisdiction was not a mere dispute, but one involving outright fraud. On such facts, it is not surprising that

*The District Court's statement that *Fox Metal* and *Governor Clinton*, "did not involve contractual arrangements that had been submitted to the Bankruptcy Court for its formal approval" (Werker A. 334) overlooks the fact that there had been court approval of the contract in those cases.

the court held that it had jurisdiction to remedy the fraud in question:

"Here a contract was made with the debtor in possession and a fraud worked on its estate through a common conspiracy among the respondents. This amounts to a fraud and imposition *upon the court itself*.

* * *

... Such enforcement of contracts *made with the court officers*, or remedy for fraud in the execution or performance of them, is a necessary step in the proper administration of the estate, and well within the powers of a bankruptcy court acting essentially as a court of equity." 120 F.2d at 152-3. (Emphasis supplied.)

The common thread of these two cases is obvious. In both cases, a fraud or imposition was worked upon the statutory agent of the court for the administration of the estate, the receiver in one case and the debtor in possession in the other. The subject of the dispute was money of the estate or due to the estate. Therefore, correction of the fraud or imposition against the estate and the court fell under the recognized statutory jurisdictional umbrella of "proceedings in bankruptcy," *United States Fidelity & Guaranty Co. v. Bray*, 225 U.S. 205 (1912). In other words, neither court created a new basis of jurisdiction but considered the case before it to be within one of the recognized bases of jurisdiction: the administration of the estate by the officers of the court so charged by statute.

There are no comparable facts in the instant case. The agreement under consideration here was an agreement between Mangels, a third party, and the chairman of the creditors committee, a third party.* The dispute involves funds

* In the court below, Mangels demonstrated that the creditors committee, unlike a receiver, trustee, or debtor in possession, is in no

which are in no conceivable sense either money of the estate or due to the estate. Accordingly, the assertion of jurisdiction based upon the principles of the above-discussed cases must fail.

The third case upon which Judge Werker appears to place some lesser reliance, *Sherman Plastering*, falls factually into the same pattern as the other two cited cases. There, the dispute arose out of a three party compromise, worked out in the chambers of the bankruptcy referee, with one of the parties thereto being the debtor in possession. This court held that, inasmuch as the complaining third party had participated in the compromise proceeding before the referee, and had also affirmatively sought adjudication of the dispute by the referee at a prior time, there had been consent to the jurisdiction of the Bankruptcy Court for the resolution of the dispute, pursuant to the specific grant in Bankruptcy Act §2a(7), 11 U.S.C. §11a(7) (1970), of jurisdiction over controversies relating to the collection of the bankrupt estate.

The District Court attempted to bring this case within the holding of *Sherman* by suggesting that Mangels consented to the jurisdiction of the Bankruptcy Court with respect to the agreement with the creditors committee because the separate agreement granting Mangels a security interest in Fabric Tree's assets had been submitted to that court for approval and because Mangels had been physically present in the Bankruptcy Court on occasion. However, research has revealed no case where a person has been deemed impliedly to have consented to the court's jurisdiction to determine rights in a contract to which the debtor was not a party because he observed hearings in a proceeding in which he was interested or because another agreement

sense an arm of the court charged with administering the estate. This demonstration below went unchallenged by any citations whatever and the District Court did not suggest that its finding of jurisdiction was based upon a view of the creditors committee as an officer of the court.

to which he was a party was submitted by the debtor to the court for its approval.*

There is, on the other hand, a plethora of cases where appearances before the Bankruptcy Court for one purpose or even applications for relief were deemed not to constitute consent to its jurisdiction for another purpose. In *In re Oceana International, Inc.*, 376 F.Supp. 956 (S.D.N.Y. 1974), a secured creditor had sought and been refused leave from the Chapter XI court to reclaim and foreclose upon its collateral, assets of the debtor. Thereafter the Chapter XI proceeding was replaced by a straight bankruptcy, and the secured creditor renewed its application and was granted relief. Subsequently a new Chapter XI petition was filed, the ordinary bankruptcy proceeding stayed, and the debtor in possession commenced a summary action against the secured creditor seeking an order declaring the sale of the collateral to be void for several alleged reasons. The secured creditor objected to jurisdiction on several grounds, and Judge Weinfeld on appeal held that its earlier requests for relief did not constitute consent to the debtor's lawsuit.

"The theory that the Bank consented to the court's summary jurisdiction is without substance. Here the Bank did not give its affirmative consent; to the contrary, it expressly challenged the bankruptcy court's jurisdiction to determine the issues raised in summary proceeding. The referee never passed upon this defense although he ordered dismissal of the proceeding on the grounds noted above. Upon filing of the Petition for Arrangement, the debtor was in possession of all property mentioned in the mortgage. The court had power to stay enforcement of the Bank's lien to protect the debtor's estate as to any possible equity over and above the secured

*Indeed, the very dictum of *Sherman* quoted by Judge Werker in a footnote as support for his position is demonstrably inappropriate, since by its own terms the statement refers to a party which "enters into an agreement *before the referee*." 340 F.2d at 919-20. (Emphasis supplied.)

debt for the benefit of creditors during the existence of the arrangement proceeding. The Bank perforce was compelled to apply to the bankruptcy court for permission to foreclose its lien, the validity of which was not then challenged. Since its action was only defensive and it sought no affirmative relief, the Bank cannot be deemed to have consented to summary jurisdiction. Any theory of consent is negated by the Bank's resistance to jurisdiction over the proceeding wherein it advanced the affirmative defense of lack of jurisdiction." 376 F.Supp. at 960-1.

The instant case is an even weaker one for a finding of consent, since Mangels never sought relief from the court, neither offensively or defensively. Rather, the debtor, with the approval of the creditors committee, submitted the loan agreement (not the escrow agreement) to which Mangels was a party to the court for its approval. This it clearly had to do, since the debtor in possession needed the court's permission to accept loans and to grant a security interest in its assets. But Mangels sought nothing from the court, did not appear before the court and, as the record makes abundantly clear, objected to jurisdiction in the instant action in a clear and timely fashion (A. 51-53). Its presence in the courtroom as an observer at several public hearings, without an appearance or participation, can hardly be sufficient under the *Oceana* rationale.

This court voiced a similar view in *In re 671 Prospect Avenue Holding Corp.*, 118 F.2d 453 (2d Cir. 1941):

"It is urged that the bank's consent to summary procedure may be found in the prior litigation concerning its lien, but the contention is unsound. Though the invalidity of the bank's lien has been established, the bank's liability to pay damages for injury to, or conversion of, the chattels has never been adjudicated; and the issue of liability presents a controversy which the bank is entitled to have tried out in a plenary suit, if it so wishes." 118 F.2d at 455.

See also *In re Kirchoff Frozen Foods, Inc.*, 496 F.2d 84 (9th Cir. 1974); *In re Schoenberg*, 70 F.2d 321 (2d Cir. 1934); *In re Bergstrom*, 1 F.2d 288 (7th Cir. 1924); *Tamasha Town & Country Club v. McAlester Construction Finance Corp.*, 252 F.Supp. 80 (S.D. Cal. 1966).

All of the foregoing bases for denying implied consent exist with even stronger force in the instant case. Mangels at the time of the evidentiary hearing had not sought any money from the estate; indeed, it had not sought any relief at all from the bankruptcy court whether offensive or defensive, or even formally appeared in the bankruptcy court. Nor is there involved here a compulsory counterclaim, since there was never even a claim asserted.

Thus, in the instant case, neither the submission by the debtor of the loan agreement for approval by the court, nor Mangels' attendance in the audience at public hearings, constitutes consent to jurisdiction for disputes arising out of the escrow agreement to which the debtor was not a party and which was never before the court.

Not only are the cases relied upon by Judge Werker inapposite, but, as Judge Werker himself noted, two of the cases cited by Mangels below establish the lack of any such jurisdiction in terms of traditional analysis. Both *Bayview Estates, Inc. v. Bayview Estates Mobile Home Owners Association*, 508 F.2d 405 (6th Cir. 1974) and *In re H. L. Gentry Construction Co.*, 200 F.Supp. 546 (E.D. Mich 1961), *aff'd* 314 F.2d 945 (6th Cir. 1962) held that the bankruptcy court lacks summary jurisdiction over escrow funds established by parties other than the debtor.

The result is even more compelling in the instant case where the debtor is neither a party to this escrow agreement nor interested in the escrow fund. Nor is this conclusion altered by the fact that release of the escrow funds was conditioned upon the entry of an order of confirmation.

Despite Judge Werker's view, the court cannot take jurisdiction merely because the debtor's ability to propose and

confirm a plan is affected by the resolution of the escrow question. That fact does not turn the matter into a "proceeding in bankruptcy." *In re New York and Worcester Express, Inc.*, 294 F.Supp. 1163 (S.D.N.Y. 1968); *Hollywood National Bank v. Bumb*, 409 F.2d 23 (9th Cir. 1969). If it did, it would result in granting unlimited jurisdiction to bankruptcy courts whenever its exercise of jurisdiction is thought to be needed for ease of administration. Such a broad assumption of jurisdiction would be contrary to all of the statutory limitations on summary jurisdiction and the hundreds of cases interpreting those restrictions.

In the final analysis, the assertion of jurisdiction by the courts below was occasioned by the accident that the amount conditionally offered by Mangels to finance the plan was not merely a contractual proposal, but was secured by the certificate of deposit in the hands of an interested party who was glad to surrender the money in derogation of his contractual obligations to Mangels as escrow agent. It cannot seriously be doubted that the Bankruptcy Court could not summarily and without pleadings have entered a judgment against Mangels for \$600,000 for its alleged breach of its obligation to fund the plan had there been no escrow deposit. Since, as demonstrated above, escrow deposits with third parties are not subject to the jurisdiction of the Bankruptcy Court, that court was without power to render judgment against Mangels.

POINT II

THE MANNER IN WHICH THE CONTROVERSY WAS RESOLVED VIOLATED MANGELS' RIGHTS TO DUE PROCESS.

Even if it were to be assumed that the Bankruptcy Court had jurisdiction, that jurisdiction was exercised in such a way as to violate Mangels' right to due process. At its

core, this controversy involved the construction of a contract. The creditors committee contended that the conditions thereof had been met and Mangels contended to the contrary. Hanging in the balance of this controversy was \$600,000. There were present, then, all of the elements of an adversary proceeding as that term is defined in Bankruptcy Rule 11-61. Yet none of the procedures set forth in the Bankruptcy Act and Bankruptcy Rules with respect to such proceedings was followed. No complaint outlining this claim was ever filed, no answer defining the issues was served and no discovery was taken. Rather, the court below, in a proceeding that knows no precedent, peremptorily convened a hearing which encompassed only 154 pages of transcript and summarily determined the rights of the parties. In the process, Mangels was denied even the most basic protections that have come to be expected in the resolution of contested matters. As Professor Moore has noted:

“[A] judgment by a court having jurisdiction over both subject matter and the parties is void where it proceeds *in such an arbitrary or improper manner that its action may be said to constitute a denial of due process.*” 7 Moore, Federal Practice #60.25 [2] at 309 (2d ed. 1975). (Emphasis added.)

Accord, *Bass v. Hoagland*, 172 F.2 205 (5th Cir. 1949); *Winhoven v. United States*, 201 F.2d 174 (9th Cir. 1952).

The procedure adopted here was not unlike that adopted by the bankruptcy referee in *In re Maki*, 14 F.2d 626 (W.D. Mich. 1926). In that case the referee dispensed with pleadings in a turnover proceeding. The reviewing court held that this was a denial of due process and defined that term as follows:

“The basic principle of English jurisprudence is that no man shall be deprived of life, liberty, or property without due process of law, *without a course of legal*

proceedings according to those rules and forms which have been established for the protection of private rights." Id. at 628. (Emphasis supplied.)

It then stated:

"A careful examination of this matter convinces the court that indispensable requisites of a fair hearing in accordance with the fundamental principles set forth in the foregoing authorities were not accorded to bankrupt. . . . *The interests of both creditors and bankrupts demand that such proceedings shall be entirely regular. A petition should have been filed containing definite averments, stating specifically what sum of money or what particular property the bankrupt was supposed to be concealing or withholding, and the bankrupt should have had a full and fair opportunity to be heard in his own behalf and to make his defense. Because of the failure to accord him his fundamental rights in these particulars the petition to revise must be sustained and the order of the referee annulled.*" Id. at 628. (Emphasis added.)

Accord, *In re Bosak*, 6 F.Supp. 958 (M.D. Pa. 1934); *In re Ruos*, 164 Fed. 749 (E.D. Pa. 1908); *In re Dobbins*, 2 F.Supp. 535 (S.D.N.Y. 1932); *In re Gottardi*, 114 Fed. 328 (S.D. Col. 1902).

The "rules and forms" which have been "created to protect the private right of parties" are those set forth in the Bankruptcy Act and Bankruptcy Rules. Bankruptcy Rule 11-61 requires adversary proceedings to resolve questions involving "money or property." There are no other types of proceedings sanctioned by the Bankruptcy Act or Bankruptcy Rules for the resolution of disputes involving third party claims to money or property.

Moreover, the Bankruptcy Rules do more than just create a proceeding; they also give substance to the manner in which it is to be conducted. Thus issues are to be framed by formal pleadings, Bankruptcy Rule 707. The parties

are entitled to the right of discovery under the Federal Rules of Civil Procedure, Bankruptcy Rule 726. And Bankruptcy Rule 701 makes the Federal Rules of Civil Procedure generally applicable to all adversary proceedings.

In view of this clear statutory plan to afford to all litigants before the Bankruptcy Court the use of those procedures generally employed in all litigated matters, the denial of the use of those procedures in this case is prejudicial and reversible error.

Nor can it fairly be said that Mangels knowingly waived its right to those procedures. That holding of the District Court is insensitive to the strained circumstances in which Mangels found itself on July 27 and ignores what actually occurred on July 15. At the hearing on July 15, no attack was or could have been made upon Mangels. It had performed its part of the contract but the debtor and the creditors committee manifestly had not performed theirs. Judge Lesser was prepared to adjudicate and was persuaded to the contrary only because of the serious prejudice to all interested parties that would have resulted. In short, as stated above (p. 8), when Mangels left the court on that day it had no reason to believe that on the day that Judge Lesser set for a status report the creditors committee would claim compliance with the contract or that Mangels would be thrust into an immediate trial of that issue.

Nor was Mangels privy to whatever events occurred between July 15 and July 27. Indeed even during the hearing on the morning of July 27 it was not at all clear what was about to transpire.* Thus, contrary to Judge Werker's finding, Mangels was taken by complete surprise when Judge Lesser ordered an evidentiary hearing to commence immediately. At the outset of the afternoon hearing coun-

* In fact, Judge Lesser stated in the morning that he did not "think that it is my job" to determine whether there had been a default under the contract (A.32-3). Of course, this is precisely what Judge Lesser undertook to determine in the afternoon.

sel for Mangels objected to the court's jurisdiction to construe the agreement and stated that he was proceeding but had "not waived any rights whatsoever", to which the court replied: "I have no problem with that" (A. 53).

Although it is true that Mangels did not raise specifically with its jurisdictional objection an objection to the nature of the proceeding, it is also true that it had not waived "any rights whatsoever". Moreover, it is fair to say that an objection with respect to the nature of the proceeding was embraced in the jurisdictional objection since even if the court had jurisdiction to construe the contract, it did not have jurisdiction to proceed in an arbitrary way and without regard to settled practices. Nor can Mangels' failure to raise a specific objection be deemed to be a knowing and intelligent waiver of its procedural rights. After all, counsel was not aware until the last moment that Mangels' substantive rights were to be adjudicated. He had no real opportunity to discuss the matter with his client, or properly to reflect upon all of the ramifications resulting from the court's action or to seek assistance and advice from more senior attorneys. Instead, thrust immediately into the heat of the fray, he made what objections he reasonably could.

This, then, is not a case where, after a complaint was served, an objection was not raised in a subsequently served answer. Nor is it a matter that had been pending for some time so that a failure to raise an objection somewhere in the proceeding reasonably could lead to the inference that a waiver was intended.

Since none of these elements is present in this case, it cannot be said that Mangels knowingly waived any rights. Yet that is precisely the standard against which the claim of waiver must be measured. As the Supreme Court said in *Ohio Bell Tel. Co. v. Public Utilities Comm'n*, 301 U.S. 292, 307 (1937):

"[W]e do not presume acquiescence in the loss of fundamental rights."

Merriken v. Cressman, 364 F. Supp. 913, 919 (E.D. Pa. 1973) gave expression to the same view in summarizing a number of Supreme Court cases:

"Before dwelling on the question of 'informed consent', it should be noted that the case before the Court is a civil case. The Supreme Court has indicated that in civil cases as well as criminal cases the Court should indulge in every reasonable presumption against waiver of procedural due process and an individual's Constitutional rights. See *Fuentes v. Shevin*, 407 U.S. 67, 92 S. Ct. 1983, 32 L. Ed. 2d 556 (1971); *Ohio Bell Telephone Co. v. The Public Utilities Comm.*, 301 U.S. 292, 307, 57 S. Ct. 724, 81 L. Ed. 1093 (1936); and *Aetna Insurance Co. v. Kennedy*, 301 U.S. 389, 393, 57 S. Ct. 809, 81 L. Ed. 1177 (1936)."

The rule to be applied was stated most aptly in *Brady v. U.S.*, 397 U.S. 742, 748 (1970):

"Waivers of constitutional rights not only must be voluntary but must be knowing, intelligent acts done with sufficient awareness of the relevant circumstances and likely consequences."

The record shows that Mangels made all the objections it reasonably could have been expected to make in the unusual and strained circumstances in which it found itself. For this reason it cannot be deemed to have waived its right to have the agreement construed by a procedure in accordance with fundamental and established norms.

Moreover, the proceeding below was so fundamentally defective and so lacking in the basic rights and protections to which litigants before the federal bar are entitled, that this Court, in the interests of justice, should order a new and full trial, whether or not Mangels sufficiently raised its objections below. No clearer case can be made for the

exercise of this Court's supervisory powers. Here Mangels was deprived of notice, specificity of charges, discovery and adequate time to prepare its defense, all in an unnecessary and unreasonable rush to judgment. The very integrity of the judicial process demands that litigants be afforded more rights than this and justifies this Court's intervention.

This Court has, when presented with circumstances such as those present in this case, noticed errors affecting the fairness and public reputation of judicial proceedings. See e.g. *San Antonio v. Timko*, 368 F. 2d 983 (2d Cir. 1966); *Troupe v. Chicago, D. & G. Bay Transit Co.*, 234 F. 2d 253 (2d Cir. 1956). As Judge Marshall said in *Ferrara v. Sheraton McAlpin Corp.*, 311 F. 2d 294, 297-8 (2d Cir. 1962):

"But we must also remain cognizant of the responsibility of an appellate court to insure that trial court judgments have been rendered in conformity with applicable rules of law. When the integrity of a trial court's judgment has been called into question by a substantial departure from those rules, an appellate court cannot put aside this responsibility merely because of the inadvertence of appellant's counsel at trial. That responsibility compels us to reverse this judgment."

POINT III

THE DECISIONS BELOW WERE ERRONEOUS ON THE MERITS. THE CONTRACT CONDITIONS WERE NOT DULY MET.

A. Time was of the essence with respect to the confirmation of an arrangement.

With respect to the time of performance, the contract between Mangels and the chairman of the creditors committee was clear and unambiguous. It specifically called for performance "by July 15" and provided that if the

monetary conditions of the agreement were not met by that date the escrowee "shall return the Certificate of Deposit . . ." to Mangels. The courts below chose to disregard the July 15 condition contracted for by Mangels and offered several rationalizations to support their determinations.

Thus, Judge Werker suggested that July 15 could not have been important because Mangels purchased Fabric Tree primarily to convert its leases into ladies apparel stores (A. 336). However, Mangels' president had testified that only four of Fabric Tree's 30 locations were being considered for future conversion (A. 184) and Judge Werker himself acknowledged that it was "Mangels' initial intention to continue operating fabric stores at the shopping centers" (A. 36).

Likewise Judge Werker concluded that since the escrow deposit was in the form of a certificate of deposit maturing on September 2, 1976, July 15 could not have been important as a contract performance date. This conclusion is poorly reasoned. The maturity of the certificate of deposit, which was a function of interest rate and time, had nothing to do with Mangels' vital concern to know before July 15, 1976 whether it was to be in the fabric business or not.

Similarly, both courts below suggested that July 15 was not important because Fabric Tree's officers moved into Mangels' offices in late June, 1976. But that fact had nothing at all to do with Mangels' intention, expressed in the contract, to be bound or relieved of its obligation by July 15.

The key error in this series of rationalizations is in Judge Werker's conclusion that "Mangels also had to make most of its inventory commitments for the fall season in advance of the July 15, 1976 date, whether or not confirmation resulted" (A. 336). This assertion is wrong and flatly contradicted in the record. Mangels' president made clear that it was precisely because he did not want to make commitments for fall merchandise in advance of confirmation that

he insisted upon a July 15 termination date, the last day when orders could be placed so as to obtain delivery for the fall selling season (A. 180-81). In fact, so concerned was Mangels that it not be committed to the fall season without confirmation, that it originally desired a June 30 performance date and consented to the July date only during the negotiations (A. 143, 161, 180). In short, Mangels demonstrated that it had no intention to finance the purchase of fall inventory by Fabric Tree in the absence of a confirmed arrangement.

Any other course would have been less than prudent. After all, Fabric Tree had been a losing operation and had found it necessary to seek the protection of Chapter XI. Even with its pre-filing creditors held at bay by the proceeding, it was losing money as a debtor in possession (A. 142-3; 145-6; 158). Thus, it was clearly understood by all concerned that if confirmation were not forthcoming, the amount of credit extended by Mangels to Fabric Tree was subject to loss. Although Mangels was willing to extend some credit to Fabric Tree and to be exposed to the risk of some loss, it had no intention of dramatically increasing the extent of that risk by undertaking to finance Fabric Tree's losses through the fall season unless it knew before doing so that it would have control of Fabric Tree and be able to attack the causes of the loss, powers it would not have in the absence of confirmation.

Mangels thus insisted upon and obtained a contractual cut-off date for that risk. It was the error of the courts below that the contractual provision was ignored. But courts are not free to make new contracts for parties. As the court held in *Crowley v. Delaware & H. R. Corporation*, 63 F. Supp. 164 (N.D.N.Y. 1945):

"We are not at liberty to revise while professing to construe." *Sun P. & P. Ass'n v. Remington P. & P. Co.*, 235 N.Y. 338, at page 346, 139 N.E. 470, at page 471." 63 F. Supp. at 166.

Accord, *International U. of Elec. & M. Wkrs. v. General Elec. Co.*, 337 F.Supp. 817 (S.D.N.Y. 1972), where Judge Pollack held:

"Self-evidently, it is not the Court's function to re-write improvident or even inequitable understandings in the absence of fraud or other overreaching of a party to an agreement." 337 F.Supp. at 821.

See also *Guttmann v. Illinois Central R. Co.*, 189 F.2d 927 (2d Cir. 1951).

Nor have courts been reluctant to demand strict adherence to contract performance dates. In *New York & Cuba Mail S.S. Co. v. Guayaquil & Q.R. Co.*, 270 Fed. 200 (2d Cir. 1920) this Court held:

"In commercial contracts time is generally of the essence of the contract, and we think the Steamship Company was bound by her engagement to be ready to load April 16th. The use of the word 'about' in this letter did not alter the contract previously entered into." 270 Fed. at 201. (Emphasis added.)

The holding of the courts of New York State are to the same effect. In *John F. Trainor Co. v. G. Amsinck & Co., Inc.*, 236 N.Y. 392, 140 N.E. 931 (1923), the court stated:

"The general rule as to rescission of executory contracts is well understood . . . If by the contract itself the date of performance is fixed, then time is essential, and failure to perform on the day indicated is ground for a rescission." 236 N.Y. at 394.

The words of the Court of Appeals in *Gravenhorst v. Zimmerman*, 236 N.Y. 22, 139 N.E. 766 (1923), have particular application to the case at bar:

"The intent of the parties was speed; delay meant probable loss; and it is well settled that, where the contract of the parties fairly leads to the inference that time is an essential consideration and feature,

enforcement of its features will be given although the contract does not explicitly specify it. *Legnite v. Mechanics & Metals National Bank of New York* supra; *Equitable Trust Co. of New York v. Keene*, supra; *Helgar Corp. v. Warner's Features*, 222 N.Y. 449, 119 N.E. 113." 236 N.Y. at 35-36. (Emphasis added.)

Mawhinney v. Millbrook Woolen Mills, 234 N.Y. 244 (1922) and *Meier Dental Mfg. Co. v. Smith*, 237 Fed. 563 (8th Cir. 1916), give expression to the same view.*

While Judge Werker argued (A. 41) that modern courts do not routinely hold time to be of the essence, his point has no application when the facts as above recited show so clearly that time was indeed of the essence and must have been understood by the parties to be so.

B. The monetary conditions of the Agreement were not duly met.

On July 27, it was declared by Fabrie Tree for the first time that the monetary conditions of the agreement would be met because general creditors had agreed to reduce their claims and the lawyers and accountants had agreed to waive some or all of their court-awarded fees. Mangels argued then, as it does now, that even if the administrative and priority expenses would be reduced by remaining claimants to no more than \$150,000, that level had been

* For some reason, Judge Werker took exception to the vintage of the cases relied on by Mangels (A. 337). Yet of the only two cases cited in the opinion of the District Court, one was of an inferior Court of New York and decided in 1908, long before the Court of Appeals decisions cited by Mangels, and involved a delay in full performance of the contractual conditions "for a few hours." *New Jersey Co. v. Nathaniel Wise Co.*, 105 N.Y.S. 231, at 233 (App. T. 1907), *aff'd.*, 125 App. Div. 918, 109 N.Y.S. 1139 (1908).

reached only because Fabric Tree improperly diverted the proceeds of the inventory financed by Mangels.*

The intention of the parties in this connection was expressed in the record clearly. Thus, the president of Mangels testified without contradiction (although the principals of the debtor were there to testify to the contrary) that the parties understood, under the May 4 agreements, that:

1. Mangels would lend sufficient funds to Fabric Tree to permit it to purchase inventory and continue operations;
2. Fabric Tree was free to use the proceeds of the sale of that inventory to pay all debts incurred after May 4, 1976;
3. Mangels would pay no more than \$450,000 to Fabric Tree's general creditors; and
4. Mangels would pay no more than \$150,000 to priority claimants, holders of Fabric Tree's post-petition pre-May 4th debt, the professionals rendering services to Fabric Tree in the arrangement proceeding, and statutory costs of the proceeding (A. 173-177).

This understanding is the only possible reading of the contract. By the terms of the agreement Mangels undertook to provide no more than \$150,000 for "*payment in full of all priority claims and expenses of administration in the Chapter XI . . .*" (emphasis supplied). By that agreement Mangels clearly intended to limit the amount it would pay to satisfy Fabric Tree's old debt. The amount of that debt was not a matter of idle concern. At the time that the contract was executed Fabric Tree could not state with assurance what its total liabilities were. Indeed, it had not even filed the monthly schedules of income and expenses

* It is not at all clear that the debt had been reduced to \$150,000 since the statements of counsel for the debtor in this regard are virtually unintelligible. The amount of the debt and its constituent elements appear shrouded in mystery and confusion.

required by Bankruptcy Rule 11-30. In view of this uncertainty as to Fabric Tree's liabilities, a limit on the amount Mangels would pay was fixed.

Thus, after estimating what it would cost to operate Fabric Tree until July 15 and after undertaking to advance sufficient credit to meet the costs of that operation, Mangels fixed the upper limit of its exposure for old debts, professional fee and statutory costs at \$150,000. Obviously, this limitation would not be effective if Fabric Tree were free to divert the proceeds of Mangels' loans, or the proceeds of the financed inventory, to the reduction of the pre-May 4 debt. Mangels could not afford so open-end an undertaking, for it would have resulted in it bailing out, without limit, all prior extenders of credit to Fabric Tree although their identity and the amount of their claims were unknown. Since Mangels had no intention of assuming so large an exposure, it established the \$150,000 condition as the limit it was willing to pay to reduce old debts and never expected that Mangels itself would be the source of the funds to met that limitation.

Since this limitation was expressed so clearly in the agreement, the courts below attempted to avoid its impact by finding that Mangels waived the protection of the agreement. But this finding of waiver, when scrutinized, is seen to be based on assumptions not justified by the record or contrary to the record.

Both courts below assumed that Mangels controlled and supervised Fabric Tree from the beginning; that Mangels was aware of the expenses being paid by Fabric Tree and that Mangels impliedly, if not expressly, consented to the payment of pre-May 4th debt. These assumptions are not warranted by the record. The facts are:

1. Mangels did not supervise Fabric Tree's operations;
2. Mangels believed that Fabric Tree was using current revenues to pay current expenses, including the purchase of

new inventory, all of which was within the contemplation of the parties;

3. Since Mangels believed that Fabric Tree was using current revenues properly, it saw no reason to employ the cumbersome procedures set forth in the loan agreement requiring Fabric Tree to remit its daily proceeds to Mangels;

4. Mangels was not aware (until late June) that Fabric Tree was paying pre-May 4 debt (A. 172);

5. When, in mid-June, Fabric Tree's officers moved in with Mangels, Mangels did not control its operation, as is evidenced by the fact that it did not prevail in its attempts to prevent Fabric Tree from paying old debts when it learned of this practice for the first time (A. 172, 202).

These facts are hardly the elements from which a waiver of contractual provisions may be made. On the contrary, they demonstrate with certitude that the parties fully intended to limit the amount Mangels was willing to pay for Fabric Tree.

Nor is there any substance to Judge Werker's charge that the assertion by Mangels of the \$150,000 limit was "baseless" (A. 338). In this regard, it is fair to say that the District Court never understood this part of the case. Judge Werker asserts that Mangels "cannot seriously contend" that the pre-May 4 administration costs which were wrongfully paid should be included in the \$150,000, because Mangels recognized that current operating costs were not included in the \$150,000 (A. 337, 338). Thus, Judge Werker confused the distinction between the pre-May 4 old administrative claims to be covered by the \$150,000 and the "working capital" costs incurred after May 4 which Mangels undertook to finance. On the basis of this misunderstanding, he built up a charge of bad faith and alleged that Mangels "wrongfully" prevented confirmation on July 15. So con-

fused is this accusation that it failed to take account of the undisputable facts, acknowledged by Judge Lesser, that the debtor had not been able to bring even the still unpaid pre-May 4 claims within \$150,000 by July 15 or to document that alleged result by July 27. Yet out of this confusion come all of the charges of bad faith levelled against Mangels.

The simple answer to this claim is that although Mangels agreed to pay Fabric Tree's post-May 4 expenses, it did not agree to pay more than \$150,000 in satisfaction of all of Fabric Tree's pre-May 4 debt—and certainly did not sanction the diversion of Fabric Tree's revenues to meet that condition.

CONCLUSION

Mangels, acting in good faith and after arms-length negotiations, entered into a contract having significant monetary conditions. Those conditions were not met on the appointed date and for some substantial time thereafter. The courts below have done nothing less than to excuse the creditors committee of the default and to order specific performance of a contract remade by the courts. In the process, the Bankruptcy Court's jurisdiction has been exceeded and a proceeding shorn of fundamental due process sanctioned. Nothing in the relationship of the parties justifies the imposition upon Mangels of such untoward consequences.

Accordingly, it is respectfully requested that the decision below be reversed.

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Service of two (2) copies of
the within Brief is hereby admitted this

15th day of MARCH, 1977

Levinson Warkentin
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Service of two (2) copies of
the within Brief is hereby admitted this

15th day of March, 1977

Hahn, Hesse Margolis & Ryan
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